Nos. 12,618 and 12,619

IN THE

United States Court of Appeals

For the Ninth Circuit

MOLLY A. HARKNESS, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent,*	No. 12,618
	(CONSOLIDATED CASES)
FLOYD J. HARKNESS, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 12,619

REPLY BRIEF FOR PETITIONERS.

PHILIP S. EHRLICH,
ALBERT A. AXELROD,
R. J. HECHT,
IRVING ROVENS,
2002 Russ Building, San Francisco 4, California,
Attorneys for Petitioners.

Subject Index

Table of Authorities Cited

Cases

Codes

Rules

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I.

BASIC ERRORS UNDERLYING RESPONDENT'S ARGUMENT.

1. **Respondent Misconceives the Scope of Review.**
2. **Respondent Misconceives the Rule of Culbertson v. Commissioner, 337 U.S. 733, 93 L.Ed. 1659 (1949).**

Certain basic errors underlie and permeate the whole of Respondent's argument as set forth in his brief. In substance, these errors may be stated as follows:

1. The Respondent has misconceived the scope of review of decisions of the Tax Court.

2. The Respondent misconceives the rule of *Culbertson v. Commissioner,* 337 U.S. 733, 93 L. Ed. 1659 (1949).

The Respondent contends that the findings and decision of the Tax Court should not be reversed because they are supported by the following evidence in the record:

(a) During the year 1943, Petitioners' children and their son-in-law did not contribute capital originating with them and rendered no services (Respondent's Brief, pp. 23-26).

(b) During the year 1943, the Petitioner, Floyd J. Harkness, was the manager of the partnership business and the only active partner, and the children and their son-in-law did not participate in the management (Respondent's Brief, pp. 26-28).

(c) During the year 1943, the children used their share of the partnership profits to pay principal and interest on the notes given by them to Petitioners, and to increase the capital of the partnership (Respondent's Brief, p. 30).

(d) During the year 1943, the share of the profits allocated to the children amounted to $71,645.00 each, or a return on their investment of more than 200% (Respondent's Brief, p. 31).

It is the position of the Respondent that the ultimate finding of the Tax Court that Petitioners and

their children had no intent to join together in conducting the business of the partnership, is not erroneous because it is supported by the evidence above outlined. In other words, it is the position of the Respondent that the finding of the Tax Court is not vulnerable on review because it is supported by some evidence. In this connection it should be noted that the Respondent in his argument has not considered or discussed other relevant and material evidence in the record which should have been considered by the Tax Court in making its determination with respect to the reality of the partnership.

All of this indicates that Respondent misconceives the scope of review and the right of this Court on appeal to set aside the findings of the Tax Court if they be clearly erroneous (F.R.C.P., 52(a)), even though there may be some evidence in the record to support them. This Court is not compelled to accept findings arrived at by accepting part of the evidence and totally disregarding other convincing evidence. (*N.L.R.B. v. Union Pacific Stages,* 99 Fed. (2d) 153, 177 (C.C.A. 9, 1938.))

The basic error of Respondent on the question of the scope of review stems from his failure to recognize that the rule of *Dobson v. Commissioner,* 321 U.S. 231, 88 L. Ed. 641 (1944) applied by the Supreme Court in *Commissioner v. Tower,* 327 U.S. 280, 90 L. Ed. 670 (1946), is no longer controlling. The rule was legislated out of existence by Congress in 1948 when it amended Section 1141 (a) of the In-

ternal Revenue Code. This amendment provides that this Court may review the decisions of the Tax Court "in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury."

Prior to 1948, and when the *Dobson* rule was still in effect, the findings of the Tax Court could not be disturbed if there was any evidence in the record to support them.

The question, therefore, before this Court, is not whether there is any evidence in the record to support the ultimate findings of the Tax Court, but whether the ultimate findings are clearly erroneous. In deciding this question, this Court should be guided by the oft-quoted language of the Supreme Court in *United States v. United States Gypsum Company,* 333 U.S. 364, 395, 92 L. Ed. 746, 766 (1948):

> "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed."

A consideration of the entire evidence in this cause leads inevitably to the conclusion that a mistake has been committed. The Respondent being aware of this fact misconceives and misstates the rule in the *Culbertson* case, supra, in an attempt to persuade this Court not to review the entire evidence. In the Petitioner's opening brief we reviewed and discussed at length events which occurred subsequent to the first

year in which the partnership operated, in an effort to show this Court that the conduct of the parties during those years led unavoidably to the conclusion that they had intended in good faith to join together in the conduct of a partnership business. Respondent would persuade this Court not to consider this evidence, as well as other evidence in the Record. This evidence shows, among other things, that Petitioners' son and son-in-law, in 1942-43 made a present commitment to render services in the future, and that this engagement was fulfilled to the letter. This evidence likewise shows that after Petitioners' children performed their obligation to pay their debt to Petitioners—a debt secured by their respective interests in the assets and income of the partnership—they had free and untramelled use and enjoyment of their respective shares of the profits of the partnership. Respondent would persuade this Court not to consider this evidence on the basis of certain language which appears in the opinion of Mr. Chief Justice Vinson in the *Culbertson* case. There the Chief Justice stated:

> "* * * The vagaries of human experience precludes reliance upon even good faith intent as to future conduct as a basis for the present taxation of income."

To the foregoing statement there is appended a footnote which reads as follows:

> "The *reductio ad absurdum* of the theory that children may be partners with their parents before they are capable of being entrusted with

> the disposition of partnership funds or of contributing substantial services occurred in *Tinkoff v. Commissioner,* 120 Fed. (2d) 564, where a taxpayer made his son a partner in his accounting firm the day the son was born."

On the basis of the statements above quoted, the Respondent concludes that it is the law that the events to which we have alluded may not be considered in appraising the reality of the partnership, because they did not occur during the taxable year in question (Respondent's Brief, pp. 26-29). In so doing, the Respondent confuses the purport of the Chief Justice's statements with the effect of a rule of administrative convenience. The Respondent believes that because "net income must be computed with respect to a fixed period, and usually that period is twelve months and is known as the taxable year",[1] that all evidential factors which may be considered in determining the question of intent must occur during the period, upon the basis of which, net income must be computed, and that if they do not, such evidential factors must be disregarded.

In making the above quoted statements the Chief Justice was not laying down a rule of evidence. It is clear from the language used that he was appraising the facts disclosed by the Record in that case in the light of human experience. He determined that, measured by this standard, the commitments made by the *Culbertson* children had only a remote possibility

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[1] *Royal Highlanders v. Commissioner,* 1 T.C. 184, 191 (1942).

of fulfillment, and were, therefore, insufficient consideration to support the bargain made with the parents.

Experience teaches that most agreements and engagements made by men are entered into on the basis of probabilities and with a reasonable expectation that they will be fulfilled. These agreements and engagements are not held unenforceable and invalid merely because it is not *absolutely certain* they can or will be fulfilled. In the case used by the Chief Justice to illustrate the *reductio ad absurdum* of alleged family partnerships, there could be no probability or reasonable expectation that a newly born infant would fulfill a commitment which he had no power to make and which had been made for him by his father. However, as we move from this ridiculous extreme to cases where adults are concerned and where the evidence discloses that they are ready, willing and able to fulfill their engagements at the very earliest opportunity, the expectations are reasonable and the probability of the performance of commitments increases to the point that neither the Respondent nor the Tax Court may substitute their judgment for that of the parties. We are not here dealing with cases involving infants, school boys and college students. The statements of the Supreme Court in the *Culbertson* case were addressed to a Record that showed that of the four Culbertson children only one of them was an adult and sufficiently mature to determine with a reasonable degree of probability his future conduct; of the other

Culbertson children, two were in high school and a third in college. Accordingly, when these statements were made, Chief Justice Vinson had in mind that as to the boys attending high school, the probability of fulfilling a commitment to render future services was remote and that the same could also be said of the boy who was in college. It is clear, therefore, that rulings made in cases involving infants and adolescents are not applicable here.

The Respondent seeks to further buttress its erroneous position by what is stated in the brief and laconic opinion of the Court of Appeals for the Fourth Circuit in *Ritter v. Commissioner,* 174 F. (2d) 377 (1949). (Respondent's Brief, p. 19.) That this case has no application here is made evident by what appears in the findings and opinion of the Tax Court in *Ritter v. Commissioner,* 11 T.C. 234 (1948). The findings and opinion of the Tax Court disclose the following:

(a) The alleged partner, a college boy, acquired an interest in his father's contracting business by gift.

(b) The father, during the existence of the alleged partnership, entered into transactions not in the name of the partnership, but in his name as an individual.

(c) The son, during the existence of the partnership, did not withdraw the share of partnership profits allocated to him.

The foregoing are important differences which clearly distinguish this case from the *Ritter* case. In the *Ritter* case the findings of the Tax Court, on the entire evidence, were clearly correct, not clearly erroneous as they are here.

II.

RESPONDENT CORRECTLY STATES CERTAIN OF THE APPLICABLE PRINCIPLES, BUT ERRS IN HIS ANALYSIS OF PETITIONERS' ARGUMENT.

Respondent states at pages 13 and 14 of his brief:

> "The controlling principles were enunciated in Commissioner v. Tower, 327 U.S. 280, and Lusthaus v. Commissioner, 327 U.S. 293, were reaffirmed in Commissioner v. Culbertson, 337 U.S. 733 and have been applied by this court and other courts in a legion of family partnership cases. 'The issue is who earned the income and that issue depends on whether this husband and wife (here a father and children) really intended to carry on business as a partnership.' Commissioner v. Tower, supra, page 289. As stated in the Culbertson case (page 742) the test is 'whether considering all the fact * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise' ".

Petitioners agree that the foregoing is a correct statement of the principles that should govern this case. However, they sharply disagree with Respondent

in his interpretation of the contentions they have advanced in support of their argument as to the bona fides of this partnership. Respondent states at page 21 of his brief:

> "Stripped to its essentials, his argument reduces itself to the contention flatly rejected in the Culbertson case that the Tax Court was obliged to conclude that both his children were partners during the taxable year merely because he sold portions of his capital to each with the expectation that one of them (his son) would contribute services in future years."

Whether or not the cases cited and principles stated by Respondent stand for the proposition he advances is of no importance on this appeal, as Petitioners contend that Respondent's interpretation of their argument is totally erroneous. A reading of their opening brief discloses that Petitioners' entire argument is based on the good faith and intent of the parties in entering into the partnership as measured by the tests set forth by the Supreme Court in *Commissioner v. Culbertson.* Petitioners argued the validity of the sales to the children and the commitments of the two boys to render services to the partnership as only two of the many factors to be taken into account by this court in passing on the bona fides of the arrangement. That Respondent is clearly in error in his interpretation of Petitioners' argument and that Petitioners have based their argument on the factors set forth in Culbertson for determining the bona fide intent of the

parties will very clearly be shown in the summary of the Record that follows:

A. Purposes Which Motivated Formation of Partnership.

1. The desire of Harkness, Sr., to obtain services of son and son-in-law (R. 253).

2. The need for increasing capital of the business and the satisfaction of this need by getting persons into business who agreed it was essential and proper to allow annual profits to accumulate (R. 254).

3. A decline in profits was anticipated (R. 254).

4. The desire of Harkness, Sr., to give his children an opportunity to make good (R. 255).

5. Harkness, Sr., would have entered arrangement regardless of tax consequences (R. 256).

B. Relationship of Parties.

1. Partnership composed of father, mother and two adult children (R. 259).

2. One child married with distinct economic and family unit (R. 252).

3. Son capable of supporting himself (R. 252).

4. No obligation of support owed to either child by taxpayers (Cal. Civil Code 174, 206).

C. Conduct of Parties During Formative Stages.

1. Mature deliberations months before partnership formed between all parties concerned (R. 256).

2. Harkness, Jr., eagerly accepted father's offer to become a partner. This had been his desire for many years (R. 246).

3. Tax Court finding: Petitioners and Harkness, Jr., then definitely planned to convert the business into a partnership, starting in 1943 (R. 256).

4. Daughter given opportunity to invest in United Packing Co., or some other enterprise (R. 256).

5. Daughter and husband debated at length whether she should invest in United Packing Co. (R. 256).

6. Daughter and husband discussed original agreement with legal counsel (R. 224-225).

7. Daughter decided to invest in United Packing Co., but would not sign original articles until provisions as to control of business and purchase of deceased partner's interest were changed (R. 256-257).

8. Tax Court finding: By November 1942, Petitioners and both their children generally agreed to the formation of a partnership for the operation of United Packing Co. in the coming year though the details of the partnership relation had not been worked out (R. 256-257).

9. Modifications sought by daughter discussed in January, 1943 (R. 259).

10. Daughter withdraws objections when original draft altered to meet her demands (R. 259).

D. Public Notoriety Given to Formation and Early Operations of Partnership.

1. Certificate of co-partnership transacting business under fictitious name signed by all parties, published in local paper and filed with Fresno County Recorder (R. 115, 257).

2. Immediately after formation of partnership, letterheads changed to show business being conducted as partnership (R. 188).

3. Grant deed to River Ranch which was recorded, had attached thereto bill of sale which showed that personal property was transferred to Petitioners and their children as copartners, doing business under the firm name and style of United Packing Co., (R. 72).

E. Partnership Agreement.

1. To bind partnership, Harkness, Sr. needed consent of one other copartner (R. 263-264).

2. No partner could transfer his share in partnership without written consent of two other copartners (R. 264).

3. Harkness, Sr. required to render account every year (R. 264).

4. Capital could only be increased by action of three partners (R. 266).

5. Capital only could be reduced and profits withdrawn by action of three partners (R. 265).

6. In event partner wished to sell interest, he must first offer it to remaining partners (R. 266).

7. If any partner became deceased, remaining partners given right to purchase his interest (R. 267).

8. Partners agreed to share equally in losses. (R. 269).

9. Harkness, Sr.'s salary set at 75% of first $100,000 of partnership net income (R. 259).

10. In no phase of business could Harkness, Sr. act alone except in every day transactions of business.

The Tax Court at no place in its findings and opinion casts any doubt upon the reality and validity of partnership agreement.

F. Respective Abilities of Parties.

1. Harkness, Jr. worked in father's business during summers from 1934 to 1941 (R. 252).

2. Harkness, Jr. worked full time from June, 1941, through January, 1942 (R. 252).

3. Harkness, Jr. was thoroughly experienced in growing, packing and shipping of fruits and vegetables (R. 226-228).

(a) He had supervised and managed packing operations.

(b) He had been in charge of office.

(c) He had taken part in every phase of business.

4. William Colgate acquired knowledge of irrigation, lifeblood of the area, working for Peerless Pump Co. (R. 253).

5. Colgate expressed desire to make agriculture his life's work (R. 253).

6. Colgate majored in commerce in college; this training added to his practical experience, made him a man well qualified to undertake the type of work required by the business of the partnership (R. 253-254).

On the basis of above factors, Harkness, Sr. had valid reason and business purpose in contracting to secure the services of the two boys for the partnership.

G. Capital Contributions of Children.

1. Harkness, Jr. purchased interest with promissory note plus credit on books of sole proprietorship (R. 276).

2. Harriet Colgate purchased interest with note joined in by her husband (R. 276).

3. Notes were unconditional promises to pay (R. 190).

4. Notes secured by children's interest in United Packing Co. (R. 119-121).

5. Notes secured by income to be derived from partnership earnings (R. 263).

6. Notes secured by ability of Harkness, Jr. and William Colgate to earn.

7. Notes actually paid out of profits[2] (R. 280).

8. Harkness, Sr. also received as consideration the present commitments of Harkness, Jr. and

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[2]*Tindall v. Commissioner*, 14 T.C. No. 125 (1950). A promissory note paid out of profits of a partnership is a valid capital contribution.

William Colgate to render services as soon as circumstances permitted.[3]

9. Profits from operation of River Ranch in which each child owned a one-eighth interest as a tenant in common (R. 269-270), went into the copartnership (R. 270).

H. Actual Conduct of Business Under Agreement.

1. Prior to entering into partnership, Harkness, Sr., as sole proprietor and manager of the community, had complete unfettered power and control over the income, business and assets of United Packing Co.

2. After the formation of the partnership the following restrictions were imposed upon Harkness, Sr.:

(a) In order to bind the properties of the business he was required to obtain the consent of a partner (R. 263-264).

(b) To increase or reduce the capital of the business he had to secure the consent of two partners (R. 265).

(c) In order to fix the salaries of employees he had to secure the consent of two partners (R. 265).

(d) In order to transfer his share in the partnership he had to secure the consent of two partners (R. 264).

[3]Mr. Justice Burton in *Commissioner v. Culbertson,* supra, 337 U.S. 749, "* * * a present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations for the purposes of taxation as well as other partnership purposes."

3. After the formation of the partnership, Harkness, Sr., was required to:

(a) Account to other partners for his actions in managing business (R. 265).

(b) Offer his interest first to other partners in event he wished to sell (R. 266).

(c) Act for the best interest of all parties concerned in his operation of the business (R. 264).

(d) Not do any act whereby the capital or property of the co-partnership could be taken by execution (R. 265).

(e) Punctually pay his own separate debts (R. 266).

(f) Transfer his interest at book value to other partners in event he became financially involved in outside interests so that his share in partnership would become involved (R. 266).

4. In addition, Harkness, Sr.'s right to possess the partnership property formerly unlimited, could only be exercised for partnership purposes (California Civil Code 2419).

5. Record discloses that in connection with the one transaction, in 1943, that fell outside the ordinary course of the management of the business, the purchase of the River Ranch, the children were consulted and their consent obtained (R. 270).

No principle of law requires that the actual day to day operation of successful business must be altered in order to establish a bona fide partnership.

I. Actual Control of Income and Purposes For Which Used.

1. 1943 income—children's share: (a) Used to pay income taxes. (b) Used to pay valid obligations they owed parents (R. 280). (c) Remainder left in business in fulfillment of one of purposes motivating formation of partnership.

2. Subsequent income. (a) Proportionate distribution to members of partnership (Ex. 6F—R. 55). (b) Harkness Jr. withdrew $121,484.51 from a gross income after taxes of $225,695.26 (Ex. 6F—R. 55). (c) Harriet Colgate withdrew $100,138.48 from a gross income after taxes of $223,171.01 (Ex. 6F—R. 55). (d) Record discloses no part of income credited to children ever went back to parents except part used in repayment of notes.

The foregoing discloses that we have here more than "a mere paper reallocation of income among the family members".

K. Partnership Not Formed For Express Purpose of Reducing Taxes.

1. Harkness, Sr. expected income of business to diminish in 1943 (R. 144).

2. Harkness, Sr. would have entered partnership regardless of any tax saving possibilities (R. 149).

3. Tax Court finding: While Harkness, Sr. consulted a lawyer concerning the feasibility of converting his business into a partnership and was thus aware of the tax savings possibilities inherent therein, yet this fact was only a secondary consideration with him

and he would have entered into this arrangement regardless thereof (R. 255-256).

No evidence, such as was found in *Tower* and *Lusthaus* that Harkness, Sr. was faced with prospect of large profits and correspondingly large income taxes and sought legal advice on how to reduce taxes.

L. Actions of Parties in Subsequent Years as Evidencing Intent of Parties in Entering Into Partnership.

1. William Colgate immediately upon his release from the Army went to work for the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership up to and including the date of the hearing—January, 1949 (R. 217-222).

2. Floyd Harkness, Jr. immediately upon his release from the Army was appointed assistant general manager of the partnership and has rendered substantial managerial services to the business up to and including the date of the hearing—January, 1949 (R. 230, 241-242).

Petitioners believe the above summary of the facts in this case sufficiently answers the contentions set forth at pages 23 to 33 of Respondent's brief, except in one particular. Respondent states at page 25:

> "Taxpayer completely misconceives the Supreme Court's holding in the Culbertson case in contending (Br. 54-58) that the children must be deemed partners during the taxable year 1943 because of events which occurred in subsequent years."

Petitioners desire to make clear to this Court that this has never been their contention. Petitioners' sole contention in this regard being this Court may look at events which took place subsequent to the year 1943 as bearing on the question of the good faith and bona fide intent of the parties in entering into the partnership.

CONCLUSION.

Petitioners again point out that on the vital issue involved in this case, the *intent of the parties*, Respondent has offered no evidence. There is no evidence in the record to impugn the bona fides of this partnership or the good faith of the parties involved. Petitioners contend that the ultimate finding of the Tax Court in this case, that the parties had no intent to enter into a partnership in the year 1943, is clearly erroneous, and that for this reason the decision of the Tax Court must be reversed.

Dated, San Francisco, California,
December 26, 1950.

Respectfully submitted,

Philip S. Ehrlich,
Albert A. Axelrod,
R. J. Hecht,
Irving Rovens,
Attorneys for Petitioners.